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Robert Van De Veire

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SECONDARY LIABILITY UNDER SECTION 10(b) OF THE SECURITIES ACT OF 1934 AND RULE 10b-5 POST-*STONERIDGE*

ROBERT VAN DE VEIRE*

INTRODUCTION

Despite the inability of the *Stoneridge Investment Partners, LLC v. Scientific Atlanta, Inc.*¹ decision to completely settle the debate over the extent of secondary liability in securities fraud actions, the case has opened discussion of the extent to which liability can and should be extended to secondary actors. The *Stoneridge* decision has been predominantly considered to be the result of the United States Supreme Court's (the "Court") disapproval of potentially widespread imposition of scheme liability to secondary actors.² As such, the *Stoneridge* decision may mark the end of private securities actions alleging "scheme liability" under Section 10(b) of the Securities Exchange Act of 1934 (the "'34 Act")³ and Rule 10b-5 promulgated thereunder.⁴ However, this decision does not have to end the possibility of private actions under Rule 10b-5 or completely insulate secondary actors in such schemes from liability to the shareholders

*Robert M. Van De Veire - B.A. Economics, Drew University; J.D., St. John's University School of Law 2010.

¹ 552 U.S. 148 (2008).

² See Todd G. Cosenza, *Applying Stoneridge to Restrict Secondary Actor Liability under 10B-5*, 64 BUS. LAW. 59, 59 (Nov. 2008) (noting that the Court's decision raised questions regarding the precise scope of scheme liability to secondary actors); see also Andrei Takhteyev, *Who is to Blame? (and What is to Be Done?): Liability of Secondary Actors Under Federal Securities Laws and the Alien Tort Claims Act*, 74 BROOK. L. REV. 1539, 1553 (2009) ("[T]he Court reiterated the premise that only primary violations of Section 10(b) are subject to private suits and a plaintiff seeking to recover against a secondary actor in a securities fraud action must prove every element of the primary violation . . .").

³ 15 U.S.C. § 78j(b).

⁴ 17 C.F.R. § 240.10b-5 (2007); see Howard K. Gordon & Tracy V. Schaffer, *The SEC's Role in Pursuing Secondary Actors Following 'Stoneridge'*, LAW.COM, May 27, 2008, <http://www.law.com/jsp/ihc/PubArticleIHC.jsp?id=1202421673135> (discussing the SEC's authority to pursue secondary actors as aiders and abettors of primary securities law violators); see also Ann Maxey, *SEC Enforcement Actions Against Securities Lawyers: New Remedies vs. Old Policies*, 22 DEL. J. CORP. L. 537, 565 (1997) ("The [Private Securities Litigation Reform Act of 1995] authorized the SEC to seek injunctive relief against secondary actors.").

of the injured corporation. This Note proposes that where the secondary actor participated in a fraudulent scheme and received a benefit at the expense of the target corporation, and hence the shareholders of that corporation, said shareholders should be permitted to bring a suit to recover any ill-gotten gains from the secondary actors. Thus, the private right of action should be preserved to allow shareholders to recover from secondary actors, while insulating the corporation from liability, as the corporation itself is not the guilty actor.

First, this Note will cover the basics of liability under §10(b) of the '34 Act and Rule 10b-5. In that context, this Note will discuss the decision in *Central Bank Securities Litigation* and the enactment of the Private Securities Litigation Reform Act. Next, this Note will compare and contrast the three tests developed in the district courts to determine liability for secondary actors under 10b-5. Third, this Note will discuss the decision in *Stoneridge Investment Partners*. Fourth, it will address the issue of the liability of secondary actors post-*Stoneridge*. It will discuss the concept that stock drop actions are a "zero sum" game, the burden of enforcement *Stoneridge* has placed on the government, and two district court decisions post-*Stoneridge*. Finally, this Note will articulate why the decision in *Lopes v. Viera* is a step in the right direction.

I. BASICS OF 10b-5 LIABILITY UNDER SECTION 10(b)

Following the 1929 stock market crash that led to the Great Depression, Congress passed two securities acts: the Securities Act of 1933 ("the '33 Act") and the '34 Act.⁵ One of the purposes of these acts was to protect investors from fraudulent securities practices through "numerous carefully drawn civil remedies and criminal penalties."⁶ The '34 Act contained §10(b), which was intended to be a "catchall" antifraud provision."⁷ Under §10(b), it is unlawful for any person to:

use or employ, in connection with the purchase or sale of any security. . . any manipulative or deceptive device or contrivance of such rules and regulations as the [SEC] may prescribe as necessary or appropriate in the public interest or for the protection of investors.

⁵ See Albert J. Matricciani, Jr., *Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc.: Substitution of Congressional Intent with Caveat Emptor*, 4 J. BUS. & TECH. L. 187, 188–89 (2009) (explaining that "the purpose of which was to protect investors from fraudulent securities activities."). See generally *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 194 (1976) ("Federal regulation of transactions in securities emerged as part of the aftermath of the market crash in 1929.").

⁶ Matricciani, Jr., *supra* note 5, at 189 (citing *Hochfelder*, 45 U.S. at 195).

⁷ *Id.* (citing *Herman & Maclean v. Huddleston*, 459 U.S. 375, 382 (1983)).

Congress also gave the Securities and Exchange Commission ("SEC") authorization to create regulations under the two acts. Thus, in 1942, the SEC enacted rule 10b-5 pursuant to §10(b). Rule 10b-5 states that:

[i]t shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

(a) To employ any device, scheme, or artifice to defraud,

(b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in light of the circumstances under which they were made, not misleading, or

(c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.⁸

The courts have implied a private right of action pursuant to Rule 10b-5.⁹ A successful claim under 10b-5 requires: (1) a material misrepresentation or omission by the defendant, (2) scienter, (3) a connection between the misrepresentation or omission and the purchase or sale of a security, (4) reliance upon the misrepresentation or omission, (5) economic loss and (6) loss causation.

Courts have determined that a misstatement is "material" if the statement or omission substantially alters the "total mix" of information available to the reasonable investor.¹⁰ The scienter element is satisfied if the plaintiff can show that the defendant had "the intent to deceive, manipulate, or defraud."¹¹ The plaintiff must also prove that he relied on the deceptive information, which is very difficult to prove on an individual level.¹² In a class action, however, there is a rebuttable presumption of class-wide reliance in two situations: (1) where the claims are primarily ones of fraudulent omissions of information that the defendant had a duty to disclose ("*Affiliated Ute* presumption"),¹³ and (2) under the fraud-on-the-

⁸ §240.10b-5.

⁹ See Cosenza, *supra* note 2, at 61 ("As is well-known, the implied private right of action under Rule 10b-5 was recognized in the lower courts as early as 1946 and acknowledged by the Supreme Court in 1971."); see also *In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 494 (S.D.N.Y. 2005).

¹⁰ See Cosenza, *supra* note 2, at 62; see also *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976).

¹¹ Cosenza, *supra* note 2, at 62 (citing *Hochfelder*, 425 U.S. at 193).

¹² See *id.* ("A securities class action generally fails if proof of individual reliance is required."); see also *Castano v. Am. Tobacco Co.*, 84 F.3d 734, 745 (5th Cir. 1996).

¹³ "Under the circumstances of this case, involving primarily a failure to disclose, positive proof of

market doctrine, under which reliance is presumed when a false statement becomes public.¹⁴

A. Aiding and Abetting Liability Under Section 10(b)

Beginning in the late 1960s, federal courts began to permit private aiding and abetting actions under §10(b).¹⁵ *Brennan v. Midwestern United Life Ins. Co.* was the first case to impose such liability.¹⁶ *Brennan* involved the fraudulent sale of stock in Midwestern United Life Ins. Co. ("Midwestern Life") by the defendant brokerage firm Dobich Securities Corp. ("Dobich").¹⁷ Dobich led the plaintiffs to believe that it had sold them stock in Midwestern Life when, in actuality, no purchase of stock had been made.¹⁸ Rather, Dobich used these funds as operating capital.¹⁹ The plaintiffs in *Brennan* alleged that the defendant, Midwestern Life, knew of this fraud and aided and abetted Dobich in its commission.²⁰ The Court, in permitting a private aiding and abetting action, noted that the '34 Act is directed at maintaining a "securities market that is free from fraudulent practices" and that "[t]he investor's protection is the paramount consideration"²¹

B. Central Bank

In 1994, in *Central Bank of Denver v. First Interstate Bank of Denver*,²² the Supreme Court limited the responsibility secondary actors had to

reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact." *Affiliated Ute Citizens of Utah v. U.S.*, 406 U.S. 128, 153-54 (1972) (internal citations omitted).

¹⁴ See Cosenza, *supra* note 2, at 62; see also *In re DVI, Inc. Sec. Litig.*, 249 F.R.D. 196 (E.D. Pa. 2008).

¹⁵ See, e.g., *Central Bank of Denver v. First Interstate Bank of Denver*, 511 U.S. 164, 169 (1994); *Brennan v. Midwestern United Life Ins. Co.*, 259 F.Supp. 673, 675 (N.D. Ind. 1966).

¹⁶ 259 F.Supp. 673 (1966).

¹⁷ *Id.* at 675.

¹⁸ *Id.*

¹⁹ *Id.*

²⁰ *Id.* "A basic philosophy of the Securities Exchange Act of 1934 is disclosure and is directed toward the creation and maintenance of a post-issuance securities market that is free from fraudulent practices. The investor's protection is the paramount consideration of much of the federal securities legislation and, in particular, of the 1934 Act here involved. The effect on an investor of an issuer corporation's failure to disclose improper activities of a brokerage firm dealing heavily in the issuer's stock, where the broker's activities create an appreciable risk of loss to that investor, may be just as dangerous and equally as damaging as a failure by the issuer to disclose information of its own improper activities affecting the value of its stock." *Id.* at 680.

²¹ *Id.* at 680.

²² 511 U.S. 164 (1994).

shareholders of the subject corporation by eliminating aiding and abetting as a basis of liability in an action brought under §10(b).²³ The Court took a textual approach in reaching this holding. Specifically, the Court held that “[b]ecause the text of §10(b) does not prohibit aiding and abetting . . . a private plaintiff may not maintain an aiding and abetting suit under §10(b).”²⁴

The events underlying this decision involved a default on 1986 and 1988 issues of bonds by the Colorado Springs-Stetson Hills Public Building Authority.²⁵ Central Bank served as indenture trustee for the \$26 million issue to finance real estate development by AmWest.²⁶ As the bonds were secured by land, AmWest, under the indenture, was required to submit annual reports to ensure that the value of the land was the requisite 160% of the value of the outstanding principle and interest on the bonds.²⁷ In 1988, the report submitted by AmWest showed appraisal values nearly identical to those in 1986, despite the declining real estate market.²⁸ The underwriter became concerned that the 160% mark was not being met.²⁹ After an in-house appraiser with Central Bank reviewed the new report, he suggested that Central Bank have an outside appraisal conducted.³⁰ However, Central Bank delayed this appraisal at the request of AmWest, and the issuer ultimately defaulted on the 1988 bonds, including \$2.1 million worth of bonds purchased by the respondents, First Interstate Bank of Denver and Jack K. Naber.³¹ Respondents then brought suit, claiming violation of §10(b) of the ‘34 Act.³² The Court found for the petitioner, holding that the language of the statute did not allow for aiding and abetting liability.³³

Although the Court did not find there to be liability with respect to Central Bank, it did mention that primary liability could still be imposed provided that the secondary actor violated Rule 10b-5.³⁴ The Court was

²³ *Id.* at 191 (holding that the language of the statute does not sustain a private lawsuit for aiding and abetting under § 10(b)); see Gordon & Schaffer, *supra* note 4 (noting that the Court in *Central Bank* did not find that § 10(b) liability extended to aiders and abettors).

²⁴ *Central Bank*, 511 U.S. at 191.

²⁵ *Id.* at 167.

²⁶ *Id.*

²⁷ *Id.*

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.* at 167–68.

³¹ *Id.* at 168.

³² *Id.*

³³ *Id.*

³⁴ *Id.*

clear, however, that each and every requirement of Rule 10b-5 must be met for there to be liability.³⁵

After the *Central Bank* decision, Congress enacted the Private Securities Litigation Reform Act ("PSLRA").³⁶ The PSLRA provided for aiding and abetting liability, but only allowed the SEC to bring such actions.³⁷ Consistent with *Central Bank*, Congress did not permit a private right of action for aiding and abetting. However, it made clear that it was intent on continuing the prosecution of aiders and abettors. This forced private plaintiffs to show that the aider and abettor met every element of primary liability under §10(b).³⁸

II. LIABILITY PRE-STONERIDGE

By leaving the door open for primary liability to be imposed on secondary actors without offering much guidance to the lower courts as to how a secondary actor could "make a material misstatement," the Supreme Court further complicated this area of the law.³⁹ The application of secondary actor liability remained inconsistent.⁴⁰ Therefore, having little guidance from the Supreme Court in the *Central Bank* decision as to what it means to "make" a material misstatement, the circuit courts instituted various standards to determine if a statement was "made."⁴¹ The courts sought to trek through the grey areas between secondary and primary actor liability without violating the Supreme Court's prohibition on aiding and abetting liability.⁴²

³⁵ "Any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under *Rule 10b-5* are met." *Id.* at 191 (citing Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 CAL. L. REV. 80, 107-08 (1981)).

³⁶ 15 U.S.C. § 78a (2006); Richard A. Booth, *The Future of Securities Litigation*, 4 BUS. & TECH. L. 129, 131-32 (2009).

³⁷ See § 78a. See also Booth, *supra* note 36; § 78t(e).

³⁸ See 15 U.S.C.A. § 77z-2; see also Cosenza, *supra* note 2, at 66.

³⁹ See Cosenza, *supra* note 2, at 66; see also Taavi Annus, *Scheme Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 72 MO. L. REV. 855, 859-60 (2007).

⁴⁰ See Cosenza, *supra* note 2, at 66; see also Annus, *supra* note 39; *Central Bank*, 511 U.S. at 169.

⁴¹ See Cosenza, *supra* note 2, at 66; see also Annus, *supra* note 39; *Central Bank*, 511 U.S. at 191 (stating that any person or entity who employs a manipulative device or makes a material misstatement may be held liable as a primary violator of 10b-5, assuming all the requirements under 10b-5 are met).

⁴² See Cosenza, *supra* note 2, at 66; see also Annus, *supra* note 39; *Central Bank*, 511 U.S. at 169-70 (noting that a theory of secondary liability was not viable to allow for a claim of aiding and abetting in light of recent Supreme Court decisions interpreting federal securities law).

A. The Creator Standard

The SEC proposed its own test, “the creator standard,” to clarify whether a statement was made.⁴³ The SEC sought to create a moderate standard which would not cast too broad of a net, so as to encompass all secondary actors, but not grant active participants in a fraud essentially a free pass by forcing plaintiffs to clear too high of a hurdle.⁴⁴

Under the creator standard, a secondary actor is primarily liable to a third party investor if it “creates” a misrepresentation, regardless of to whom the statement is publicly attributed.⁴⁵ To meet the standard of reliance, the plaintiff must prove that the secondary actor 1) knew or was reckless in not knowing that investors would rely on this statement, 2) knew or was reckless in not knowing of the existence of the material misstatement, and 3) played so significant a role in the creation of the misrepresentation that the secondary actor could be fairly characterized as an author or co-author of the document.⁴⁶

The Third Circuit eventually adopted the creator standard in *Klein v. Boyd*.⁴⁷ The *Klein* court held that a law firm could be primarily liable under §10(b) and Rule 10b-5 even if the investing public was unaware of its participation in drafting the misleading documents.⁴⁸ The court articulated that no actual endorsement of the document on the part of the preparing attorney is needed.⁴⁹ The court reasoned that, by participating in the preparation of a document with the knowledge that it will be publicly distributed to investors, the attorney has elected to speak to the investing public, regardless of whether he or she is given credit.⁵⁰

⁴³ See Cosenza, *supra* note 2, at 67; see also Brief of the Securities and Exchange Commission, Amicus Curiae at 14–16, *Klein v. Boyd*, Nos. 97-1143, 97-1261, 1998 Fed. Sec. L. Rep. (CCH) P 90,136 (3d Cir.), *vacated for reh’g en banc*, 1998 Fed. Sec. L. Rep. P 90,165 (3d Cir. 1998), available at <http://www.sec.gov/litigation/briefs/klein.txt>.

⁴⁴ See Cosenza, *supra* note 2, at 67; see also Brief of the Securities and Exchange Commission, *supra* note 43.

⁴⁵ See Cosenza, *supra* note 2, at 67; see also Brief of the Securities and Exchange Commission, *supra* note 43.

⁴⁶ See Cosenza, *supra* note 2, at 67; see also Brief of the Securities and Exchange Commission, *supra* note 43.

⁴⁷ 1998 Fed. Sec. L. Rep. ¶ 90,136 (3d Cir.). “A lawyer who can fairly be characterized as an author or a co-author of a client’s fraudulent document may be held primarily liable to a third-party investor under the federal securities laws for the material misstatements or omissions contained in the document, even when the lawyer did not sign or endorse the document and the investor is therefore unaware of the lawyer’s role in the fraud.” *Id.*

⁴⁸ *Id.*

⁴⁹ *Id.* at ¶ 90,324. See Cosenza, *supra* note 2, at 66 (citing *Klein*, 1998 Fed. Sec. L. Rep. at ¶ 90,318).

⁵⁰ *Klein*, 1998 Fed. Sec. L. Rep. at ¶ 90,136. “The Third Circuit also opined that a lawyer preparing a document with the knowledge that it will be given to investors ‘has elected to speak to the

B. The Substantial Participation Test

The Ninth Circuit chose to allow plaintiffs to cast a larger net than the Third Circuit by employing a broader standard for reliance that became known as the “substantial participation test.”⁵¹ For a secondary actor to be primarily liable under this standard, it need only have substantially participated in the preparation of materially false or misleading statements.⁵²

Like the creator standard, the substantial participation test relies only on the secondary actor’s knowing participation in the preparation of the misleading public disclosures.⁵³ However, what matters under this standard is that investors relied on misstatements that were made to the investing public, not that the public knew who actually made them.⁵⁴ Even if the public cannot directly attribute the misstatements to a secondary actor, the misleading statements were still made to and relied upon by the market, and as such, “anyone intricately involved in their creation and the resulting deception should be [held] liable.”⁵⁵

C. The Bright Line Test

In almost direct contrast to the substantial participation test, the Second, Tenth, and Eleventh Circuits took a strict approach to determine whether a material misstatement had been made.⁵⁶ These courts applied the “bright

investors, even though the document may not be facially attributed to the lawyer.” Cosenza, *supra* note 2, at 68 (citing *Klein*, 1998 Fed. Sec. L. Rep. at ¶ 90,318).

⁵¹ *Klein v. Boyd*, 1998 U.S. App. LEXIS 4121 (3d Cir. 1998). See Cosenza, *supra* note 2, at 66.

⁵² See *Klein*, 1998 U.S. App. LEXIS at 4121; see also Cecil C. Kuhne, *Expanding the Scope of Securities Fraud?: The Shifting Sands of Central Bank*, 52 DRAKE L. REV. 25, 37 (noting “[t]he Ninth Circuit has been the most vocal proponent of expanding liability to secondary actors under the guise of a substantial participation test.”).

⁵³ See *In re Software Toolworks Inc. v. Painewebber Inc.*, 50 F.3d 615, 626 (9th Cir. 1994) (defining the mental state requirements of the substantial participation test), *cert. denied sub nom*; see also *Montgomery Securities v. Dannenberg*, 516 U.S. 907 (1995); Cosenza, *supra* note 2, at 66 (explaining that the substantial participation test focuses on a party’s knowing participation in preparing a misrepresentation, rather than the identity of the statement’s particular author).

⁵⁴ See *In re ZZZZ Best Sec. Litig.*, 864 F.Supp. 960, 970 (C.D. Cal. 1994) (holding that although the misstatements and omissions at issue could not be attributed to a particular author, the fact that they were relied upon was sufficient to hold any party involved in their creation liable); see also Cosenza, *supra* note 2, at 66 (discussing the holding in *In re ZZZZ Best*).

⁵⁵ *In re ZZZZ Best*, 864 F.Supp. at 970.

⁵⁶ See *Ziembra v. Cascade Int’l, Inc.*, 256 F.3d 1194, 1205 (11th Cir. 2001) (following the Second Circuit in requiring that the misstatement at issue be publicly attributable to the defendant); see also *Wright v. Ernst & Young LLP*, 152 F.3d 169, 175 (2d Cir. 1998) (requiring that a misrepresentation be specifically attributed to a particular actor in order to impose liability), *cert. denied*, 525 U.S. 1104 (1999); *Anixter v. Home-Stake Products Co.*, 77 F.3d 1215, 1226–27 (10th Cir. 1996) (concluding that liability should only be imposed upon those who themselves make false or misleading statements); Cosenza, *supra* note 2, at 65 (attributing the stricter standard used in these circuits to the courts’

line test” in making their determinations.⁵⁷ To satisfy the bright line test, the secondary actor must have actually published the material misstatement.⁵⁸ Mere participation in its creation is insufficient to impose liability.⁵⁹ Simply put, a plaintiff can only prove reliance under this standard if the secondary actor is named in the document, has signed the document, or is otherwise identified to investors at the time the misrepresentation is published to the market.⁶⁰

III. STONERIDGE

In response to the overwhelming grey area between primary and secondary actor liability under Rule 10b-5, private plaintiffs attempted to bridge the gap by arguing that secondary actors should be held liable under a theory that became known as “scheme liability.”⁶¹ Under “scheme liability,” the plaintiffs do not attempt to reach secondary actors based on 10b-5(b), which prohibits making fraudulent statements or making certain omissions.⁶² Rather, in proving “scheme liability,” plaintiffs base their claims on Rule 10b-5(a) or (c), which prohibit the use of any “device, scheme or artifice to defraud” or “to engage in any act, practice, or course

struggle to respond to the demise of aiding and abetting liability).

⁵⁷ See *Ziemba*, 256 F.3d at 1205 (following the Second Circuit’s preference for the bright line test); see also *Wright*, 152 F.3d at 175 (choosing the bright line test over the substantial participation test); *Anixter*, 77 F.3d at 1226–27 (refraining from calling the test a bright line but recognizing that it provides more guidance than the substantial participation test); Cosenza, *supra* note 2, at 65 (specifying the Second, Tenth, and Eleventh Circuits as those which applied the bright line test).

⁵⁸ See *Ziemba*, 256 F.3d at 1205 (requiring that misstatements be publicly attributable to defendants in order to impose liability); see also *Wright*, 152 F.3d at 175 (explaining that “a defendant must actually make a false or misleading statement in order to be held liable under Section 10(b).”); *Anixter*, 77 F.3d at 1226–27 (requiring that defendants themselves make the false statements in order to be held liable); Cosenza, *supra* note 2, at 65 (contrasting this requirement with the more broad requirement of mere participation under the substantial participation test).

⁵⁹ See Cosenza, *supra* note 2, at 65 (“Under the bright line test, the secondary actor must actually publish a material misstatement that is attributed to it, rather than merely participating in its creation.”); see also *Anixter*, F.3d at 1226–27 (“[W]e conclude that in order for accountants to ‘use or employ’ a ‘deception’ actionable under the antifraud law, they must themselves make a false or misleading statement”).

⁶⁰ See Cosenza, *supra* note 2, at 65 (stating that a secondary actor is only liable if they are named on the document and have signed it); see also *Shapiro v. Cantor*, 123 F.3d 717, 720 (2d Cir. 1997) (interpreting case law to determine that anything short of conduct will not trigger liability under Section 10(b)).

⁶¹ See *Scope of Secondary Actor Liability*, 122 HARV. L. REV. 485, 485 (Nov. 2008) (“[P]rivate plaintiffs began arguing that participation in a scheme to violate the securities laws could be treated as a primary violation, a theory known as ‘scheme liability.’”); see also Annus, *supra* note 39, at 862 (explaining how plaintiffs have begun to use scheme liability to fill the gap).

⁶² See *Scope of Secondary Actor Liability*, *supra* note 61, at 487 (discussing the limits of secondary actor liability); see also Annus, *supra* note 39, at 859 (mentioning that “plaintiffs have alleged that secondary actors have been so closely involved in drafting financial and other corporate statements that they have actually made those statements in violation of Rule 10b-5(b).”).

of business which operates or would operate as a fraud or deceit upon any person.”⁶³ Plaintiffs argue that by participating in allegedly deceptive conduct, the secondary actor engaged in a “scheme to defraud investors.”⁶⁴

However, in 2008, the Supreme Court rejected the “scheme liability” theory when it affirmed the Eighth Circuit decision in *Stoneridge Investment Partners, LLC. v. Scientific-Atlanta, Inc.*⁶⁵ Justice Kennedy, writing for the majority, framed the issue before the Court as whether §10(b) liability can properly attach to an entity that participated in a scheme to violate the statute, but did not actually make a public misstatement or fail to disclose material information.⁶⁶ The Court ultimately concluded that because there was no public misstatement or failure to disclose, “the investors cannot be said to have relied upon any of respondents’ deceptive acts in the decision to purchase or sell securities,” meaning that “the requisite reliance cannot be shown.”⁶⁷

Stoneridge involved allegedly fraudulent practices engaged in by Charter Communications, Inc. (“Charter”), a cable television provider, and two of its cable box providers, Scientific-Atlanta, Inc. and Motorola, Inc. (collectively the “Suppliers”).⁶⁸ Charter sought to meet Wall Street expectations for cable subscriber growth and operating cash flow.⁶⁹ To do this, Charter enlisted the aid of the Suppliers.⁷⁰ A deal was arranged surrounding the purchase of set top cable boxes from the Suppliers.⁷¹ Under the arrangement, Charter would overpay twenty dollars per box supplied with the understanding that the Suppliers would return the overpayment by purchasing advertising time from Charter.⁷² Charter received no monetary benefit from the arrangement; instead, it ultimately

⁶³ 17 C.F.R. § 240.10b-5 (2007). See Annus, *supra* note 39, at 862 (stating how courts have applied 10b-5(a) and 10b-5(c)).

⁶⁴ Matricciani, Jr. *supra* note 5, at 192 (“The theory imposes liability on any actor who participates in a scheme to defraud investors.”). See Susan E. Hurd & Elizabeth Skola, *The Stoneridge Investment Partners Decision: What Difference Has It Made?* 28 NO. 1 BANKING & FIN. SERVICES POL’Y REP. 1 (2009) (determining the necessary causal connection for secondary actors to be liable); see also § 240.10b-5.

⁶⁵ 552 U.S. 148 (2008).

⁶⁶ See *Scope of Secondary Actor Liability*, *supra* note 61, at 487 (mentioning how Justice Kennedy frames the question); see also *Stoneridge Investment Partners*, 552 U.S. at 152–53 (discussing how secondary actors agreed to arrangements lead to misleading financial statements that affected prices).

⁶⁷ *Stoneridge Investment Partners*, 552 U.S. at 166–67.

⁶⁸ *Id.* at 153–54. See Cosenza, *supra* note 2, at 69 (introducing the parties to the lawsuit and the nature of the alleged fraud).

⁶⁹ *Stoneridge Investment Partners*, 552 U.S. at 153.

⁷⁰ *Id.* (stating that “[t]o help meet the shortfall, Charter decided to alter its existing arrangements with [the Suppliers].”).

⁷¹ *Id.*

⁷² *Id.*

resulted in Charter giving away free advertising time. However, Charter recorded the advertising purchases as revenue, and contrary to generally accepted accounting principles, it capitalized the set top boxes.⁷³ The arrangement between Charter and the Suppliers was concealed by backdating the transactions, in order to make them appear unrelated.⁷⁴ In this way, Charter successfully increased its apparent cash flow by \$17 million, a figure represented to the SEC as accurate in various filings.⁷⁵

The plaintiffs filed a class action suit against the Suppliers, alleging §10(b) and Rule 10b-5 violations, in that the Suppliers knew or were in reckless disregard of Charter's intent to defraud the market.⁷⁶ The Court noted that the Suppliers had no part in preparing or disseminating Charter's financial statements.⁷⁷

The decision primarily addressed the inability of scheme liability to satisfy the justifiable reliance element of a §10(b) claim.⁷⁸ The Court identified reliance as a key element to imposing liability under §10(b):

[R]eliance by the plaintiff upon the defendant's deceptive acts is an essential element of the §10(b) private cause of action. It ensures that, for liability to arise, the 'requisite causal connection between a defendant's misrepresentation and a plaintiff's injury' exists as a predicate for liability.⁷⁹

The Court considered the fraud-on-the-market presumption of reliance, but ultimately rejected its applicability to this case. Since it was undisputed that the Suppliers engaged in the deceptive conduct along with Charter at Charter's behest, the Court focused on the proximity of the defendants' alleged deceptive acts to the actual harm incurred by the plaintiffs and whether the actions of the Suppliers took place in the "investment

⁷³ *Id.* (explaining that by projecting false revenue, it enabled "Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers"). See Venture Line, Capitalize Definition, http://www.ventureline.com/Glossary_C.asp (last visited May 6, 2009) (defining "capitalize" as "[t]o capitalize, in general business, it is to supply with capital, as of a business by using a combination of capital used by investors and debt capital provided by lenders; or, to consider expenditures as capital assets rather than expenses. Specifically, it is to: . . . b) record capital outlays as additions to asset accounts, not as expenses . . .").

⁷⁴ *Stoneridge Investment Partners*, 552 U.S. at 155 (noting that "[t]he new set top box agreements were backdated to make it appear that they were negotiated a month before the advertising agreements.").

⁷⁵ *Id.*

⁷⁶ *Id.*

⁷⁷ *Id.*

⁷⁸ See Matricciani, Jr. *supra* note 5, at 193.

⁷⁹ *Stoneridge Investment Partners*, 552 U.S. at 159 (citing *Basic, Inc. v. Levinson*, 485 U.S. 224, 243 (1988)).

sphere.”⁸⁰ The Court reasoned that actions outside the investment sphere could not reasonably be believed to have been relied upon by investors.⁸¹ In rejecting the *Affiliated Ute* presumption, the Court noted that the Suppliers had no duty to disclose, and reiterated that the public had no knowledge of the Suppliers’ acts during the relevant time period.⁸² Thus, the Court concluded that reliance could only be shown through an “indirect chain” that proved “too remote for liability.”⁸³ Additionally, the Court noted in dicta that conduct may be a permissible method of deception under §10(b).⁸⁴

While it is clear that meeting all the requirements of §10(b) will lead to a finding of primary liability, when examining the future implications of the *Stoneridge* decision, the issue of where the boundaries of liability on secondary actors under §10(b) lie is far from concrete.⁸⁵ The “too remote” language chosen by the Court is vague and offers little guidance to the district courts.⁸⁶ The broad language of the decision was initially viewed as restricting, if not completely eliminating, secondary actor liability under §10(b).⁸⁷

⁸⁰ See Cosenza, *supra* note 2, at 70 n.94. In *Basic v. Levinson*, the Supreme Court first articulated the fraud-on-the-market theory of liability in securities actions. In *Basic*, Combustion Engineering engaged in discussions with Basic’s officers and directors, seeking to acquire the company. The day before Basic’s board approved the merger, Basic’s president, Max Mueller, publicly stated that Basic was not involved in any merger discussions. After the merger went through, Max L. Levinson, a Basic shareholder, sued to recover damages resulting from the artificially depressed value of his shares as a result of Mueller’s misstatements. Here, the Court set forth the fraud-on-the-market theory as establishing a rebuttable presumption of reliance on the defendant’s misstatements, because they were made publicly to an open and developed securities exchange. The logic behind this theory is that all information regarding a security affects the price of that security, so when a statement is made to the open market, it affects the market price of that security. Therefore, an investor in that security is presumed to have relied upon that information. See *Basic*, 485 U.S. 224.

⁸¹ *Basic*, 485 U.S. at 249.

⁸² *Id.* at 243.

⁸³ *Stoneridge Investment Partners*, 552 U.S. at 158.

⁸⁴ *Id.* “The Court of Appeals concluded petitioner had not alleged that respondents engaged in a deceptive act within the reach of the §10(b) private right of action, noting that only misstatements, omissions by one who has a duty to disclose, and manipulative trading practices (where ‘manipulative’ is a term of art, see, e.g., *Santa Fe Industries, Inc. v. Green*, 430 U.S. 462, 476-477 (1977)) are deceptive within the meaning of the rule. If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous. Conduct itself can be deceptive, as respondents concede. In this case, moreover, respondents’ course of conduct included both oral and written statements, such as the backdated contracts agreed to by Charter and respondents.” *Id.* (citation omitted).

⁸⁵ See Cosenza, *supra* note 2, at 59 (discussing the decision in *Stoneridge*); see also Donald C. Langevoort, *Reading Stoneridge Carefully: A Duty-Based Approach to Reliance and Third-Party Liability Under Rule 10B-5*, 158 U. PA. L. REV. 2125, 2126 (2010) (explaining the “mishmash”).

⁸⁶ See Cosenza, *supra* note 2, at 59; see also Langevoort, *supra* note 85 (discussing how the “mishmash” led to vague interpretations); Rodney D. Chrisman, *Stoneridge v. Scientific-Atlanta: Do Section 10(b) and Rule 10b-5 Require a Misstatement of Omission?*, 26 QUINNPIAC L. REV. 839, 878-79 (2008) (displaying how the goals of the court were not fully accomplished).

⁸⁷ See Cosenza, *supra* note 2, at 59; see also Chrisman, *supra* note 86 (explaining the confusing

Nevertheless, the Supreme Court did allow for deceptive conduct to serve as a basis for liability.⁸⁸ In reflecting on the Court of Appeals decision, the Court noted that (and the respondents conceded that) “[c]onduct itself can be deceptive.”⁸⁹ Thus, requiring that a written or oral statement be required for a finding of a violation of §10(b) and Rule 10b-5 would ultimately contravene the purpose of the law.⁹⁰ For example, insider trading is a fraud properly conducted only through stealth,⁹¹ whereby a widespread public statement either oral or written would undercut the perpetrator’s purpose.⁹² The lessened standard adopted by the Court to include conduct as a method of deception may open the door to more litigation.⁹³ This is counter to the Court’s professed objective of reducing unnecessary litigation.⁹⁴

IV. POST-STONERIDGE

A. What Stoneridge Has Meant to Those Who Suffer Injury

While the boundaries of liability of secondary actors are far from concrete, what has indeed been established is that the hurdle to satisfy §10(b) liability is significantly higher. *Stoneridge* has proven difficult on plaintiffs, as it has raised the bar as to what they must prove to show that a misstatement was made, thereby making it difficult to fulfill the reliance requirement of a §10(b) claim. *Stoneridge* has effectively shortened the arms of plaintiffs seeking to reach secondary actors who may have participated in the commission of a fraud, but who essentially failed to sign their name to their crime. For example, shortly after the *Stoneridge* decision was handed down, the Court threw out a similar claim for \$40

holdings effect on secondary actors).

⁸⁸ See Cosenza, *supra* note 2, at 59; see also Chrisman, *supra* note 86, at 875 (discussing how conduct itself can be deceptive).

⁸⁹ *Stoneridge Investment Partners*, 552 U.S. at 158.

⁹⁰ *Id.* (“If this conclusion were read to suggest there must be a specific oral or written statement before there could be liability under § 10(b) or Rule 10b-5, it would be erroneous.”).

⁹¹ See Booth, *supra* note 36, at 132 (“[Insider trading] is a fraud that depends on stealth.”); see also *U.S. v. O’Hagan*, 521 U.S. 642, 651–52 (1997) (reasoning that classic insider trading is marked by disclosure of nonpublic information).

⁹² See *Stoneridge Investment Partners*, 552 U.S. at 158 (explaining that it is erroneous to conclude a specific oral or written statement must be made for liability to attach); see also Cosenza, *supra* note 2, at 72 (stating that it is doubtful whether an oral or written statement is necessary for liability to attach).

⁹³ See Cosenza, *supra* note 2, at 71 (calling attention to the fact that deceptive behavior can lead to liability); see also Chrisman, *supra* note 86, at 916 (stating that more litigation is an unintended consequence).

⁹⁴ See Cosenza, *supra* note 2, at 71; see also Chrisman, *supra* note 86, at 916 (noting that the Court was desperate to avoid more litigation).

billion by Enron investors against Merrill Lynch, Pierce, Fenner, & Smith, Inc. and other firms alleging that they had aided and abetted Enron in falsifying financials.⁹⁵ The court held that it would be impossible for the plaintiffs to prove that they relied on the deceptive behavior.⁹⁶ Thus, the Court has shown that pleadings based on claims similar to the allegations in *Stoneridge* now run the risk of being thrown out before they are heard on the merits. The concern over the constraining impact that *Stoneridge* potentially could have was evident even to the Justice Department.⁹⁷ Before the Merrill Lynch case was thrown out, the Justice Department prepared an amicus brief on behalf of the SEC, which sided with the Enron investors, but was never filed.⁹⁸

Jonathan Macey, a professor of corporate law at Yale University, summarized the reaction to the *Stoneridge* decision when he stated,

If you're in the bubble fantasy world of the plaintiffs bar and think there's social value in bringing suits, then *Stoneridge* was wrongly decided . . . It permitted people who were pretty active participants in an accounting fraud to be let off as defendants. But if you say these suits are like kudzu or cancer on corporate America, with massive amounts of costs and no benefits, then *Stoneridge* cuts away massive amounts of civil suits against extraneous parties.⁹⁹

a. Zero-Sum Game

For some commentators that disfavor "stock-drop class actions," *Stoneridge* represents an opportunity for the Court to make fundamental changes to litigation surrounding such class actions.¹⁰⁰ At the heart of these proposed reforms is the contention that stock-drop situations are a zero-sum game, meaning that "there is no fraud because there is no damage."¹⁰¹

⁹⁵ In re Enron Corp. Sec., Deriv. & ERISA Litig., 610 F. Supp. 2d 600 (S.D. Tex. 2009).

⁹⁶ *Id.* See Terry Carter, *How Lawyers Enabled the Meltdown And How They Might Have Prevented it*, 95 JAN A.B.A.J. 34, 39 (Jan. 2009).

⁹⁷ See Carter, *supra* note 96 ("In a friend-of-the-court brief prepared by the Justice Department on behalf of the SEC, the agency had sided with Enron investors."); see also Lawyers USA, *Justice Department Backs Defendants in Enron-Related High Court Case* (Aug. 2007) (noting that the SEC urged the Justice Department to file an amicus brief in support of the investors).

⁹⁸ See Carter, *supra* note 96 ("Following a complaint to the White House by Secretary of Treasury Henry Paulson, the solicitor general reversed field and filed a brief for the other side."); see also *Enron Investors' Hopes Ride with Supreme Court Case*, <http://abclocal.go.com/ktrk/story?section=news/local&id=5691772>, Oct. 6, 2007 (last visited Nov. 29, 2010) ("But the Justice Department solicitor general, after pitches from President Bush and Treasury Secretary Henry Paulson, rejected the SEC's recommendation and filed a brief on the side of Motorola and Scientific-Atlanta.").

⁹⁹ Carter, *supra* note 96 (quoting Jonathan Macey).

¹⁰⁰ Booth, *supra* note 36, at 135. See Langevoort, *supra* note 85, at 2125.

¹⁰¹ Booth, *supra* note 36 at 135.

Stoneridge is an example of such a stock-drop class action.¹⁰² Investors bought Charter stock at a price that supposedly reflected the actual value of the company.¹⁰³ However, in reality, the price paid by these investors was actually inflated due to Charter's improper revenue reporting.¹⁰⁴ But what is important in a case such as this is that the corporation itself did not sell shares in a public offering at the inflated price.¹⁰⁵ Instead, shares were purchased on the open market from other investors.¹⁰⁶ Thus, it was other investors that benefitted from Charter's fraudulent practices, rather than Charter itself.¹⁰⁷ Additionally, the investors who sold shares benefitted by the exact amount that the stock price was inflated, which is equivalent to the losses of the investors who bought shares during this time.¹⁰⁸ Admittedly, while there is a loss suffered by some investors, their collective loss is shared among other investors as an improper gain.¹⁰⁹ Therefore, in viewing the market as a whole, there is no real net loss.¹¹⁰ Moreover, for the investor who buys before the misrepresentation affects the market and holds until after it comes to light, there is no net effect on

¹⁰² See *id.* at 136; see also *Stoneridge Investment Partners*, 552 U.S. at 153 (2008).

¹⁰³ Booth, *supra* note 36, at 136; *Stoneridge Investment Partners*, 552 U.S. at 153.

¹⁰⁴ Booth, *supra* note 36, at 136; *Stoneridge Investment Partners*, 552 U.S. at 153.

¹⁰⁵ See Booth, *supra* note 36, at 136 ("[*Stoneridge*] is not a case alleging that Charter itself had fraudulently sold stock to the public at an inflated price . . . it is not a case in which Charter obtained money by a fraudulent public offering and should be made to give it back."); see also Nelson Waneka, *Stoneridge Investment Partners v. Scientific-Atlanta: Rethinking the Fraud-On-The-Market Presumption and the Policy Considerations Permeating the Court's Decision*, 86 DENV. U. L. REV. 303, 313–15 (2008) (noting that the agreements in question had no economic substance and resulted in overstated revenue, which was disseminated to the public and which occurred after the company's initial public offering).

¹⁰⁶ See Waneka, *supra* note 105 (stating that this is not a case in which Charter obtained money through fraud); see also *Stoneridge Investments Partners, LLS v. Scientific-Atlanta, Inc.*, 443 F.3d 987 (8th Cir. 2005) (noting the claim that analysts relied on the inflated revenues and operating cash flow in making stock recommendations).

¹⁰⁷ See Waneka, *supra* note 105 (describing this situation as a classic stock-drop class action, where individuals other than Charter benefitted from misrepresentations); see also *Stoneridge Investments Partners*, 443 F.3d 987 (asserting that Charter was only liable for improper accounting procedures, and did not benefit from such practices).

¹⁰⁸ See Waneka, *supra* note 105 (mentioning how the losses incurred by the bad luck of buyers are offset dollar for dollar by the good luck of investors who happen to sell at that same time); see also *Central Bank*, 511 U.S. at 178 (describing how the Securities Fraud statutory language prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act).

¹⁰⁹ See Waneka, *supra* note 105 (highlighting that the standard approach to damages in a bad news case is to award the difference between the price paid by the buyer and the market price after corrective disclosure); see also *Central Laborers' Pension Fund v. Chellgren*, No. Civ. A. 02-220-DLB, 2004 WL 1348880, at *2 (E.D. Ky. Mar. 29, 2004) (noting that gains that one company receives at the expense of others in the market place as a result of improper reporting practices are improper).

¹¹⁰ Booth asserts that securities fraud in the context of a stock drop action is a zero-sum game. Booth, *supra* note 36, at 134. A "zero sum game" is defined as "[a] situation in which one participant's gains result only from another participant's equivalent losses. The net change in total wealth among participants is zero; the wealth is just shifted from one to another." See <http://www.investopedia.com/terms/z/zero-sumgame.asp> (last visited April 19, 2009).

that investor at the time the fraud comes to light.¹¹¹

However, investors in the subject company are still injured by the impending litigation's effect on the stock price. When evidence of the misrepresentation comes to light, the share price theoretically returns to where it should have been had there been no fraud perpetrated. This equilibrium point is where the market values the shares of the subject company.¹¹² Yet, once word of a possible class action and potential liability is released to the market, share prices drop below this equilibrium point. When litigation is threatened and this news becomes public, the market reacts accordingly.¹¹³ The subject company now has a potentially large payout pending the result of the litigation. Therefore, shares in the subject company become less attractive to potential investors. Hence, the market values the shares of the subject company less, driving the price per share down.¹¹⁴ In this way, a direct suit against the subject corporation can only serve to compensate investors at the expense of the innocent shareholders of the corporation who continue to hold their shares through the litigation.

Moreover, investors can also suffer injury when the company engages in a fraud because of the outflow of money or other benefits to the secondary actors. For example, in *Stoneridge*, Charter was effectively giving away advertising time to Motorola and Scientific-Atlanta to perpetuate the fraud.¹¹⁵ Even if not especially valuable to Charter, there was still some

¹¹¹ See Waneka, *supra* note 105 (describing the situations where a potential claim of securities fraud due to misrepresentation would arise); see also Richard A. Booth, *The End of the Securities Fraud Class Action as We Know It*, 4 BERKELEY BUS. L.J. 1, 24 (2007) (concluding that there is no negative effect in a situation where the holder buys before misrepresentation, and holds until after disclosure).

¹¹² See Investopedia.com, Economics Basics: Demand and Supply, <http://www.investopedia.com/university/economics/economics3.asp> (last visited May 5, 2009) ("In the real market place equilibrium can only ever be reached in theory, so the prices of goods and services are constantly changing in relation to fluctuations in demand and supply."); see also Roger J. Dennis, *Materiality and the Efficient Capital Market Model: A Recipe for the Total Mix*, 25 WM. & MARY L. REV. 373, 379 (1983) ("[W]here many competing experts analyze the same information, trading induced by analysts will bring a particular security's price promptly to a dynamic equilibrium point . . . [a]s the product of such a process, the price of a security represents the consensus of the various competitors in the market.").

¹¹³ See Investopedia.com, Stocks Basics: What Causes Stock Prices to Change?, <http://www.investopedia.com/university/stocks/stocks4.asp> (last visited May 5, 2009) (discussing the effect of positive or negative news, and other factors, on a company's stock price); see also Andre Baker, *How to Evaluate Stock Investment Risks*, E-ARTICLES, Mar. 2007, <http://e-articles.info/e/a/title/How-to-evaluate-stock-investment-risks> ("Just the threat of a large lawsuit can weigh heavily on a company's stock price.").

¹¹⁴ See Stocks Basics: What Causes Stock Prices to Change?, *supra* note 113 (explaining that there are various factors that cause a company's stock to be less attractive to potential investors, and thus cause stock price to go down); see also Baker, *supra* note 113 (advising potential investors to "[a]void all stocks facing litigation with a potentially costly outcome.").

¹¹⁵ See *Stoneridge Investment Partners*, 552 U.S. at 160.

value of which the shareholders were being deprived through the actions of the guilty parties.¹¹⁶ It is these same investors who are then injured again when the stock price is driven down by pending litigation as mentioned above.

B. Burden on the Government

The Supreme Court has made clear that while it did not expressly allow for private enforcement, the SEC would still be able to pursue aiders and abettors.¹¹⁷ The SEC's "enforcement power is not toothless."¹¹⁸ For example, since 2002, the SEC has received over \$10 billion in disgorgement funds and monetary penalties.¹¹⁹ Despite the success the SEC has had in recent years of enforcing violations, the burden on government enforcement continues to increase.¹²⁰ In only allowing actions to be brought by the SEC, the Supreme Court has made the SEC the sole aiding and abetting watchdog. The SEC's New York Regional Director, Mark Schonfeld, even stated that "the inability of the private bar to bring actions" could increase the burden on the SEC.

There is a difference between actions brought by private litigants and those brought in an enforcement action by the SEC.¹²¹ For example, the

¹¹⁶ See *id.* at 154 ("The transactions, it is alleged, had no economic substance; but, because Charter would then record the advertising purchases as revenue and capitalize its purchase of the set top boxes, in violation of generally accepted accounting principles, the transactions would enable Charter to fool its auditor into approving a financial statement showing it met projected revenue and operating cash flow numbers."); see also Seth S. Gomm, *See No Evil, Hear No Evil, Speak No Evil: Stoneridge Investment Partners, LLC v. Scientific-Atlanta, Inc. and the Supreme Court's Attempt to Determine the Issue of Scheme Liability*, 61 ARK. L. REV. 453, 458 (2008) (explaining how such advertising arrangements negatively affect shareholders).

¹¹⁷ See *Stoneridge Investment Partners*, 552 U.S. at 158 (stating that section 104 of the Private Securities Litigation Reform Act of 1995 "directed prosecution of aiders and abettors by the SEC . . . [the] implied private right of action does not apply to aiders and abettors."); see also Gordon & Schaffer, *supra* note 4, at n.35 ("Following the ruling in *Central Bank*, Congress enacted section 104 of the Private Securities Litigation Reform Act of 1995, which authorized the SEC to enforce securities fraud violations against aiders and abettors.").

¹¹⁸ *Stoneridge Investment Partners*, 552 U.S. at 166.

¹¹⁹ See *id.* ("Since September 30, 2002, SEC enforcement actions have collected over \$ 10 billion in disgorgement and penalties, much of it for distribution to injured investors."); see also SEC, 2007 Performance & Accountability Rep. 26, available at <http://www.sec.gov/about/secpar2007.shtml> ("As a result of SEC enforcement cases, approximately \$13.8 billion in disgorgement and penalties from FY 2003 through FY 2007 were ordered to be paid to the SEC, courts, or other appointed trustees.").

¹²⁰ See Gordon & Schaffer, *supra* note 4 (explaining that SEC enforcement officials have acknowledged a greater burden on the SEC to enforce misconduct following *Stoneridge*); see also H. Lynn Stallworth & Dean Digregorio, *Improper Revenue Recognition: To Help Clients Avoid SEC Violations, Internal Auditors Need To Understand The Revenue Management Practices That Can Lead To Material Misstatements*, INTERNAL AUDITOR, Jun. 2004 (stating that the SEC has increased enforcement activity and filed a record number of accounting and auditing enforcement actions in 2003).

¹²¹ See Gordon & Schaffer, *supra* note 4 (discussing how although after *Stoneridge* private

SEC has two options in pursuing secondary actors; it can either bring an enforcement action for primary liability under §10(b), or it can bring an aider and abettor action. In the latter action, district courts employ a variety of standards as to the state-of-mind the SEC must show the defendant possessed in committing the fraud.¹²² Some courts require as little as “recklessness,” while others require “knowing.”¹²³ Additionally, unlike private litigants, the SEC need not prove the reliance element in order to succeed in an action for primary liability.

Yet, while the role of the SEC has seemingly expanded in enforcing §10(b), the tools available to the SEC have been limited.¹²⁴ Like private litigants, the SEC is bound by the Supreme Court precedent in interpreting the scope of §10(b).¹²⁵ In this way, the SEC may be limited in the future by

securities claims alleging scheme liability against secondary actors under Section 10(b) will likely end, the SEC will remain authorized to pursue these claims); *see also* Securities Exchange Commission v. Richetelli, 2010 U.S. Dist. LEXIS 68923 at 11–12 (Conn. 2010) (stating that individuals who act as aiders and abettors are not liable in private suits for violating Section 10(b), but that the SEC may seek to impose liability on these individuals).

¹²² *See* Gordon & Schaffer, *supra* note 4 (“The scienter or state-of-mind standard the SEC must meet to sustain aiding and abetting claims differs depending on the jurisdiction involved.”); *see also* Matthew L. Mustokoff, *Proving Scienter in SEC Aiding and Abetting Cases: Courts Apply Tougher Standard in Recent Decisions*, INSIGHTS: THE CORPORATE & SECURITIES LAW ADVISOR (May 1, 2006) available at <http://www.accessmylibrary.com/article-1G1-151326917/proving-scienter-sec-aiding.html> (stating that district courts have differed as to the proper standard for demonstrating scienter in litigation against aiders and abettors under Section 10(b) of the Securities Exchange Act of 1934).

¹²³ *See* Gordon & Schaffer, *supra* note 4 (explaining that while the D.C. circuit has held that recklessness is required in SEC aiding and abetting actions, at least two district courts in the Second Circuit require the SEC to prove knowing misconduct). *Compare* Ponce v. Securities & Exchange Commission, 345 F.3d 722, 737 (9th Cir. 2003) (holding that although Ponce may have had knowledge, recklessness was sufficient to satisfy the aiding and abetting scienter standard) *with* Securities and Exchange Commission v. Kushner Promotions, 417 F. Supp. 2d 326, 335 (S.D.N.Y. 2006) (stating that knowing misconduct must be shown).

¹²⁴ *See* Hurd & Skola, *supra* note 64, at 5 (“The Supreme Court acknowledged in *Stoneridge* that the SEC alone was authorized to bring aiding and abetting claims under § 10(b). Yet in the wake of *Stoneridge*, the question remained whether the decision would have an effect on the SEC’s ability to prosecute claims for primary liability under § 10(b).”); *see also* Lawrence Scheinert, *Countering The Stoneridge Critics: The Prudence of Maintaining the Status Quo for Lawyer Liability Under Rule 10B-5*, 11 FL. COASTAL L. REV. 1, 28 (stating that the *Stoneridge* court gave the SEC encouragement to increase enforcement activity).

¹²⁵ “One recent decision from the First Circuit, *SEC v. Tambone*, sheds some light on this strategy post-*Stoneridge*. *Tambone* involved an enforcement action brought by the SEC against two senior executives of a company serving as the primary underwriter for certain mutual funds. The SEC contended that these two individuals were primarily liable under § 10(b) (in addition to being aiders and abettors) through their use of false and misleading fund prospectuses to sell mutual fund shares. In assessing whether such primary liability claims were possible under *Stoneridge*, the First Circuit observed that . . . the failure to plead reliance, which was fatal in *Stoneridge*, would not necessarily preclude the SEC’s claims in *Tambone*. Rather, the primary area of dispute between the parties was whether the defendants had ‘made’ a materially false or misleading statement for which primary liability may exist under § 10(b). The First Circuit held that, by using misleading prospectuses despite an underwriter’s duty to review and confirm the accuracy of their contents, these defendants had made implied statements of their own to potential investors that they had a reasonable basis to believe that key statements in the prospectuses were accurate and complete.” Hurd & Skola, *supra* note 64, at 5–6.

the Supreme Court precedent set in *Stoneridge*, because defendants may now allege that they never made the misleading statements.¹²⁶ This could potentially handicap the SEC, which has historically brought an action against a party involved in a §10(b) violation as both a primary actor and a secondary actor who acted as an aider and abettor.¹²⁷

C. Post-Stoneridge Decisions

a. In Re DVI Inc. Securities Litigation

Only eight months after the *Stoneridge* decision, the district court for the Eastern District of Pennsylvania referenced it in the class certification in *In Re DVI Inc. Securities Litigation*.¹²⁸ Plaintiffs there sought class certification regarding claims brought against the law firms Clifford Chance LLP and Clifford Chance U.S. LLP (collectively “Clifford Chance”).¹²⁹

DVI Inc. was a firm that financed the working capital needs of medical providers by securing credit through healthcare receivables.¹³⁰ In 1997 and again in 1998, DVI issued notes to raise capital.¹³¹ During this time, Clifford Chance served as outside counsel to DVI.¹³² Shortly after DVI filed for Chapter 11 bankruptcy in 2003, DVI investors filed a securities fraud class action suit against the officers and directors of DVI, its independent auditor, its largest shareholder, and Clifford Chance. In their complaint, plaintiffs alleged that these parties participated in a massive scheme to inflate the price of DVI securities.¹³³

Clifford Chance contended that class certification as against itself would be inappropriate.¹³⁴ It argued that neither the fraud-on-the-market presumption nor the *Affiliated Ute* presumption was applicable, as Clifford Chance did not make a public misstatement that affected DVI stock or

In *Tambone*, the court held that the SEC must abide by the Court’s decision in *Central Bank*. SEC v. Tambone, 597 F.3d 436, 446 (1st Cir. 2010).

¹²⁶ See Hurd & Skola, *supra* note 64, at 5–6 (speaking about the recent decision of SEC v. Tambone); see also *Stoneridge Investment Partners*, 552 U.S. at 158–59 (2008) (stating that the conclusion that §10(b) does not extend to aiders and abettors is erroneous).

¹²⁷ See Hurd & Skola, *supra* note 64, at 6–7 (noting the risk of abusive litigation was too great); see also *Stoneridge Investment Partners*, 552 U.S. at 165 (discussing how secondary actors are subject to criminal penalties and civil enforcement by the SEC).

¹²⁸ 249 F.R.D. 196 (E.D. Pa. 2008).

¹²⁹ *Id.* at 198.

¹³⁰ *Id.*

¹³¹ *Id.*

¹³² *Id.*

¹³³ *In re DVI*, 249 F.R.D. at 198.

¹³⁴ *Id.* at 207 (stating the two presumptions established by the Supreme Court).

notes, nor did they owe a duty of disclosure to DVI investors.¹³⁵

However, plaintiffs alleged that Clifford Chance should be held liable under §10(b) and Rule 10b-5 because it substantially participated in a scheme to defraud investors.¹³⁶ Plaintiffs alleged that Clifford Chance assisted DVI in all aspects of the scheme, including “drafting fraudulent public financial reports . . . and deflecting inquiries from the [SEC].”¹³⁷ Plaintiffs alleged that not only did Clifford Chance have knowledge of the scheme, but also that they had a “unique role in initiating and masterminding” it.¹³⁸ Additionally, plaintiffs cited specific language from *Stoneridge* indicating that conduct can be deceptive.¹³⁹ Plaintiffs contended that they were entitled to a class-wide presumption of reliance as against Clifford Chance even though it was not specifically identified in the fraudulent public disclosures.¹⁴⁰ Plaintiffs argued that reliance is tied to causation, and thus, it was for the district court to decide whether the actions of Clifford Chance were “too remote” in relation to the injury suffered by DVI’s investors.¹⁴¹

The court relied largely on the reasoning in *Stoneridge* in coming to its determination that the plaintiffs were not entitled to the fraud-on-the-market presumption of reliance.¹⁴² The court noted that while *Stoneridge* recognized the relationship between causality in reliance when applying scheme liability under §10(b), it emphasized that the Supreme Court was reluctant to expand reliance based on scheme liability.¹⁴³ The court ultimately concluded that the fraud-on-the-market theory did not apply because “none of [Clifford Chance’s] alleged conduct was publically

¹³⁵ *Id.* (noting that in cases which involve primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery).

¹³⁶ *Id.* at 199.

¹³⁷ *Id.*

¹³⁸ *In re DVI*, 249 F.R.D. at 217.

¹³⁹ *Id.* at 216–17.

¹⁴⁰ *Id.* at 217.

¹⁴¹ *Id.*

¹⁴² *Id.*

¹⁴³ “In rejecting scheme liability, the Court notes that plaintiffs under this theory could not overcome the objection that investors in the cable operator ‘did not in fact rely upon [the supplier’s] own deceptive conduct.’ Similarly this Court finds that Lead Plaintiffs have not overcome the objection that investors in DVI did not rely upon the allegedly deceptive conduct of Clifford Chance. Though Lead Plaintiffs allege that Clifford Chance knew of the scheme, and at times took a more active part in assisting DVI in the scheme, the fact remains that none of this alleged conduct was publically disclosed such that it affected the market for DVI’s securities. Accordingly, this Court finds that Lead Plaintiffs are not entitled to the fraud on the market presumption to establish reliance with respect to Clifford Chance. Additionally, the Court finds that the Affiliated Ute presumption is equally inapplicable because Clifford Chance owed no duty of disclosure to DVI’s investors.” *In re DVI*, 249 F.R.D. at 217–18. See *Regents of Univ. of Cal. v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372, 384 (5th Cir. 2007).

disclosed such that it affected the market for DVI's securities."¹⁴⁴ Therefore, plaintiffs could not prove class-wide reliance.¹⁴⁵

b. *Lopes v. Vieira*

In March 2008, the district court for the Eastern District of California applied the *Stoneridge* reasoning in *Lopes v. Vieira*.¹⁴⁶ However, the court in *Lopes* came to a different conclusion as to whether a law firm could be held liable under §10(b) and Rule 10b-5, ultimately holding that the defendants could be liable since they had passed the substantial participation test.¹⁴⁷

In *Lopes*, the plaintiffs invested in Valley Gold LLC, a company founded by George Vieira, allegedly for the sole purpose of defrauding investors.¹⁴⁸ The fraud was allegedly modeled after one which Vieira had perpetuated through Suprema Specialties, Inc., a publicly traded company, for which he was then under investigation.¹⁴⁹

To perpetuate the new fraudulent scheme, Vieira needed to create Valley Gold to fill the role that Suprema had previously held.¹⁵⁰ Downey Brand LLC, a California law firm, was retained by Vieira for the purpose of forming Valley Gold.¹⁵¹ In that capacity, Downey prepared a business plan for Valley Gold and an offering memorandum for the sale of shares in Valley Gold.¹⁵² Included in this memorandum were detailed financial forecasts and the company's business plan.¹⁵³

In January 2004, Vieira pled guilty for his criminal involvement in a scheme to inflate the profitability of Suprema.¹⁵⁴ As part of this plea deal, Vieira was banned from working in the cheese and dairy business, forcing him to step down as CEO of Valley Gold.¹⁵⁵ Shortly thereafter, Valley Gold defaulted on its payment obligations to the plaintiffs for milk already supplied.¹⁵⁶

Plaintiffs sued Downey and Vieira, among others who aided in the

¹⁴⁴ *In re DVI*, 248 F.R.D. at 218.

¹⁴⁵ *Id.*

¹⁴⁶ 543 F. Supp. 2d 1149 (E.D. Cal. 2008).

¹⁴⁷ *Id.* at 1201.

¹⁴⁸ *Id.* at 1155.

¹⁴⁹ *Id.* at 1154.

¹⁵⁰ *Id.*

¹⁵¹ *Lopes*, 543 F.Supp. 2d at 1156.

¹⁵² *Id.*

¹⁵³ *Id.*

¹⁵⁴ *Id.* See generally *Lopes v. Vieira*, 2010 U.S. Dist. LEXIS 104417 (E.D. Cal. Sept. 30, 2010).

¹⁵⁵ *Lopes*, 543 F. Supp. 2d at 1156. See generally *Lopes*, 2010 U.S. Dist. LEXIS 104417.

¹⁵⁶ *Lopes*, 543 F. Supp. 2d at 1156.

creation and operation of Valley Gold.¹⁵⁷ Downey moved to dismiss, arguing that the Ninth Circuit test did not apply and citing *Stoneridge* in support.¹⁵⁸ Downey contended that they were at most an “aider and abettor,” since none of the allegedly false statements that were made publicly could be attributed to the law firm.¹⁵⁹

While recognizing the *Stoneridge* decision, the court distinguished the facts in *Stoneridge* from those of *Lopes*, and recognized that for a secondary actor to be liable, the elements for a §10(b) claim must be met.¹⁶⁰ The court noted that unlike the Suppliers in *Stoneridge*, Downey “played a significant role in drafting and editing” the fraudulent offering memorandum.¹⁶¹ Therefore, they passed the substantial participation test as set forth by the Ninth Circuit in *In re Software Toolworks Inc. Securities Litigation*.¹⁶² In determining reliance post-*Stoneridge*, the court concluded that Downey’s conduct was not too remote in relation to the injury.¹⁶³ The court also suggested that a law firm or an attorney, as opposed to a counterparty to a contract, could have an implied duty to investors, depending on the facts of each individual case.¹⁶⁴

CONCLUSION: APPROPRIATELY PLACING BLAME AND WITH IT LIABILITY

The goal of securities fraud litigation should be to return ill-gotten gains from those who benefitted to the injured parties. In a situation such as *Stoneridge*, the subject company did not benefit from the fraudulent practices of insiders and the secondary actors (absent a public sale of shares from the company’s own holdings). The benefit then is shared between the insiders and secondary actors. Therefore, it stands to reason that it is those very parties that both perpetuated the fraud and benefitted as a result who should be held liable to those who are injured.

Stoneridge essentially cut off the prospect of successful litigation against these secondary actors, or at a minimum made it harder to succeed. This result is counter to what should be the purpose of the rule. However, the district court in *Lopes* took a step in the right direction. In narrowing the scope of *Stoneridge* and continuing the application of the SEC-created

¹⁵⁷ *Id.*

¹⁵⁸ *Id.* at 1177-78.

¹⁵⁹ *Id.*

¹⁶⁰ *Id.* at 1175.

¹⁶¹ *Lopes*, 543 F. Supp. 2d at 1176.

¹⁶² 50 F.3d 615 (9th Cir. 1994).

¹⁶³ *Lopes*, 543 F. Supp. 2d at 1201.

¹⁶⁴ *Id.* at 1178.

substantial participation test, the court boosted future plaintiffs' ability to recover against secondary actors who participate in the production of fraudulent or deceptive financial statements. Under *Stoneridge* logic, it is possible that a court could hold that the plaintiffs in *Lopes* failed to meet the reliance element of 10b-5 because the actions of the defendant were questionably remote. However, the court in *Lopes* took a step in the right direction in applying the Ninth Circuit substantial participation test.

